

## Is incorporation (with limited liability) too easily available ?

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### Résumé de l'article

La constitution en corporation de sociétés commerciales est facile et peu coûteuse au Canada, tant sous la *Loi sur les sociétés par actions* que sous les lois provinciales correspondantes. Les avantages qu'en tirent les actionnaires sont aussi évidents que connus, surtout en ce qui a trait à la limite de leur responsabilité. Toutefois, la constitution en corporation, du fait de sa simplicité, peut porter atteinte de façon importante aux intérêts des créanciers volontaires et non volontaires, lorsque la société n'est plus en mesure de satisfaire à ses obligations.

L'examen que fait l'auteur des divers moyens légaux et judiciaires destinés à réprimer l'utilisation abusive de la forme corporative fait ressortir l'existence de sérieuses déficiences. Par ailleurs, il semble peu probable que les législateurs renverseront la tendance centenaire, soit en rendant plus difficile la constitution en corporation des sociétés commerciales, ou en retirant aux administrateurs et aux actionnaires des sociétés à propriété restreinte la protection de la responsabilité limitée. De l'avis de l'auteur, il existe des recours de « seconde classe » qui, même s'ils sont moins efficaces, apparaissent beaucoup plus réalistes. Parmi ces moyens de protection, on pourrait ainsi exiger que toute corporation dépose ses états financiers auprès d'une autorité publique. De plus, les administrateurs pourraient être tenus personnellement responsables des dettes de la société si celle-ci poursuivait ses affaires, tout en étant dans une situation d'insolvabilité manifeste et durable.

## Is incorporation (with limited liability) too easily available?

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Jacob S. ZIEGEL\*

*The incorporation of new businesses in Canada is remarkably cheap and easy, both under the Canada Business Corporations Act and under the provincial corporations statutes. The benefits conferred on shareholders by incorporation are obvious and well known, particularly the advantage of limited liability. Easy incorporation however also imposes significant burdens on the corporation's voluntary and involuntary creditors if the corporation cannot meet its liabilities.*

*The author examines the various statutory and judicially created techniques for restraining the abuse of the corporate form, and finds them seriously deficient. Nevertheless, he sees no likelihood of the legislature reversing a century old trend either by making incorporation much more difficult or by denying directors or shareholders in closely held corporations the protection of limited liability. He concludes therefore that "second order" remedies are much more realistic, even if less efficient. He also recommends several new remedies, including the requirement that all corporations must file a copy of their financial statements in a public office and that directors will be held personally responsible for the corporation's debts if the corporation continues to trade when it is clear that it is insolvent and likely to remain so.*

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*La constitution en corporation de sociétés commerciales est facile et peu coûteuse au Canada, tant sous la Loi sur les sociétés par actions que*

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\* Professor of Law, University of Toronto. I knew Robert Demers only slightly. Nevertheless, I am delighted to be able, in a very modest way, to join in this tribute to a gifted colleague who unhappily was taken from us very prematurely.

*sous les lois provinciales correspondantes. Les avantages qu'en tirent les actionnaires sont aussi évidents que connus, surtout en ce qui a trait à la limite de leur responsabilité. Toutefois, la constitution en corporation, du fait de sa simplicité, peut porter atteinte de façon importante aux intérêts des créanciers volontaires et non volontaires, lorsque la société n'est plus en mesure de satisfaire à ses obligations.*

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15-MINUTE CORPORATIONS IN SIX CITIES GET COMPANY. Aspiring tycoons with \$200 and a free quarter hour can now get quickie incorporations from the provincial Government in seven Ontario cities.

The latest while-you-wait incorporation outlet for time-pressed capitalists opened in Kingston yesterday, complementing service already provided in Toronto, London, Thunder Bay, Sudbury, Ottawa and Windsor...".

*The Globe and Mail*, 10 May 1983

The two most contentious corporate law concepts in the first half of the 19th century were whether incorporation and limited liability for shareholders should be made generally available for business enterprises. By 1860, after much debate and incremental progress, both questions had been answered affirmatively in Canada, the United Kingdom and the United States<sup>1</sup>, and general incorporation statutes with limited liability existed in all three countries.

Since 1860 there have been further developments, and the requirements for incorporation have been much simplified and relaxed. So have the earlier provisions concerning the raising and maintenance of share capital and other provisions for the protection of creditors of the corporation. In Canada and the U.S.<sup>2</sup>, one-person corporations are now freely permitted. The results of this policy of "enablingism" are tellingly reflected in the above quotation from *The Globe and Mail*. Even more striking are the following statistics. In 1988 alone, 138,198 new corporations were incorporated in Canada<sup>3</sup> and there were at least half a million corporations in active operation<sup>4</sup>—about the same number as for the

1. For the Canadian history of these issues, see *inter alia* A.W. Currie, "The First Dominion Companies Act", (1962) 28 *Can. J. Econ. Pol. Sc.* 387, for the British history, L.C.B. Gower, *The Principles of Modern Company Law*, 4th ed., London, Stevens, 1979, ch. 3, and for the U.S. history, E.M. Dodd, *American Business Corporations until 1860*, Cambridge, Harvard Univ. Press, 1954. See also J.S. Ziegel, R.J. Daniels, D.L. Johnston and J.G. MacIntosh, *Cases and Materials on Partnerships and Canadian Business Corporations*, Toronto, Carswell Co., 1989, 2 vols., ch. 2, esp. p. 97-103.

2. But not yet in the United Kingdom.

3. Canadian Federation of Independent Business (hereafter CFIB), *Business Growth in Canada: Business Formations in Fiscal 1988/89*, Table 2, p. 8.

4. The estimate is the author's. The total number of businesses in operation in Canada during the fiscal year 1988/89 was 1,683,000. *Id.*, Table 1. The ratio of new incorporations to newly registered proprietorships and partnerships was about .6. If this ratio is also representative of the general proportion of active corporations to the total number of active businesses, it yields a figure exceeding half a million. The number of active corporations in Ontario alone amounted to 511,766 in 1989. (Information supplied orally to author by John Flint of the Corporations' Branch of the Ontario Ministry of Consumer and Commercial Relations).

whole of the United Kingdom<sup>5</sup>. It seems clear then that both levels of government in Canada encourage incorporations and that business persons freely avail themselves of this permissiveness.

Is this a good thing? Who benefits and who suffers? Has the pendulum of public policy swung too far from hostility to general incorporations at the beginning of the 19th century to the 'open door' policy at the end of the 20th century? If public policy has erred, what can or should be done to reverse the trend, and how? These are the principal questions addressed in this short essay. Canadian corporations law usually distinguishes between public or "offering" corporations (i.e., corporations whose shares are widely held) and private or closely held corporations with only a small number of shareholders or only one shareholder<sup>6</sup>. This essay focuses on closely held corporations. The emphasis is justified because commentators generally agree<sup>7</sup> that it is much easier to explain a policy of limited liability for shareholders of public corporations than it is to justify it for shareholders of closely held corporations. The number of closely held corporations also vastly exceeds the number of public corporations<sup>8</sup>.

### 1. The origins of the closely held corporation

It is a puzzle how closely held corporations acquired such a firm grip on the legislatures' indulgence. It may have been more by accident than design. During the first half of the 19th century the advocates of general incorporation statutes and limited liability emphasized the need for private capital to finance the new roads, bridges, canals and railways that needed building and for the burgeoning new industries awaiting development, and pointed out that investors would not be willing to put up the money if they were to be held personally responsible for the enterprise's debts. None of these arguments applied to owner managed businesses and

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5. For the U.K. statistics see J.H. Farrar, N. Furey and B. Hannigan, *Farrar's Company Law*, 2nd ed., London, Butterworths, 1988, p. 34-35.

6. See F. Iacobucci and A.L. Johnston, "The Private or Closely-Held Corporation" in J.S. Ziegel (ed.), *Studies in Canadian Company Law*, Toronto, Butterworths, 1973 vol. 2, ch. 2.

7. See, for example, P. Halpern, M. Trebilcock and S. Turnbull, "An Economic Analysis of Limited Liability in Corporation Law", (1980) 30 *U.T.L.J.* 118, and F. Easterbrook and D. Fischel, "Limited Liability and the Corporation", (1985) 52 *U.Chi.L.Rev.* 89.

8. At the present time, the total number of listed companies on the Toronto Stock Exchange amounts to 1,1204, that on the Montreal Stock Exchange approximately 669. (I am indebted for this information to Mr. Ralph Shay, Director of Listings, Toronto Stock Exchange).

there is no evidence that they were pressing for the right to incorporate<sup>9</sup>. Although the early incorporation acts were not expressly limited to public corporations, their structure suggests that this is what the legislators had in mind. Typically the statutes required a plurality of shareholders and a minimum amount of paid up capital<sup>10</sup>.

In England the question came to a head with the celebrated decision of the House of Lords in *Salomon v. Salomon & Co. Ltd.*<sup>11</sup> Mr. Salomon had incorporated his one-man business under the English Companies Act 1862 and had met the requirements of the Act for a minimum of seven incorporators by giving one share each to the members of his family. The House of Lords unanimously held that this token compliance did not violate the statutory requirements. As Paddy Ireland has shown<sup>12</sup>, the result was not a foregone conclusion since business and legal opinion was widely (but not unanimously) opposed to the British *Companies Act* being used for the incorporation of small business firms. One may conjecture whether the law lords genuinely felt themselves bound by the literal terms of the 1862 Act (as they claimed to be) or whether they sympathized with the minority view that small businesses should not be denied the advantages of incorporation and limited liability available to their bigger brethren.

Whatever Parliament's original intentions may have been, it is clear that by the turn of the century the minority view prevailed. This is shown by the fact that in 1906 the Loreburn Committee on company law amendments recommended the formal recognition of private companies and their being relieved from several onerous requirements incumbent on public companies, and by the fact that the recommendations were implemented in the *Companies Act* of 1907.

These developments undoubtedly left their imprint on Canada. They were carried to their logical conclusion after World War II when the Ontario *Business Corporations Act* of 1970 explicitly authorized the

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9. Cf. J.M. Landers, "A Unified Approach to Parent, Subsidiary, and Affiliated Questions in Bankruptcy", (1975) 45 *U. Chi.L.Rev.* 589, at p. 618: "When corporation law was in its formative stage, corporations were of substantial size and were owned by a group of individual stockholders... The one-man or close corporation was a rarity, if it existed at all."

10. For the details of such provisions in the early Canadian corporations acts, see A.W. Currie, *supra*, note 1, p. 399-400.

11. *Salomon v. Salomon & Co. Ltd.*, [1897] A.C. 112.

12. P. Ireland, "The Triumph of the Company Legal Form, 1856-1914" in John Adams (ed.), *Essays for Clive Schmitthoff*, Abingdon, Professional Books Limited, 1983, p. 29, cited in J.S. Ziegel *et al.*, *supra*, note 2, at p. 117-118.

incorporation of one-person corporations<sup>13</sup>. The precedent has been followed in the *Canada Business Corporations Act* (CBCA)<sup>14</sup> and in most, if not all, of the provincial business corporations acts<sup>15</sup>. As previously noted, all but a few thousand of the more than half million active corporations in Canada are closely held and, it is safe to assume, have only a small number of employees or none other than the owner-shareholder<sup>16</sup>. While in absolute terms the total number of proprietorships and partnerships still exceeds the number of incorporated businesses, it is clear that the closely held limited liability corporation is the vehicle of choice for more than fifty per cent of all new businesses<sup>17</sup>.

## 2. The benefits and costs of incorporation

It is easy to explain why incorporation is so attractive to business persons. Compared to the unincorporated form of business, the principal advantages are threefold: the separate legal personality of the corporation, lower levels of taxation, and limited liability for the owners. While all three advantages are important, the availability of limited liability is undoubtedly the most important and common reason why lawyers recommend incorporation to their clients<sup>18</sup>. From the incorporators'

13. *Business Corporations Act*, R.S.O. 1970, c.53. See now *Business Corporations Act* 1982, (hereafter OBCA), S.O. 1982, c.4, s.4(1).

14. *Business Corporations Act*, R.S.C. 1985, c. c-44, s.5(1).

15. Including the Quebec Companies Act. See R.S.Q., c. C-38, s.123.9.

16. In 1987, 76.6 % of the 880,237 firms with paid employees had less than 5 employees and almost 98 per cent had less than 50 employees. See Canadian Federation of Independent Business, *The Small Business Sector in Canada*, Chart 1, p. 3.

17. In fiscal year 1988-9, there were 138,198 new incorporations compared with 225,957 new proprietorships and partnerships. CFIB study, *supra*, note 3, Table 1. I have no statistics for the break-down of the total number of active incorporated and unincorporated businesses, though they may well exist.

18. English shareholders' perception of the importance of limited liability is shown by the fact that, although English companies legislation has from the beginning given them an option to incorporate with limited or unlimited liability, companies with unlimited liability are very rare (297 out of 65,727 companies incorporated in 1979). This is so even though unlimited companies enjoy some important advantages. See *Companies Act* 1985, ss. 1(2)(c), 241(4), and J.H. Farrar *et al.*, *supra*, note 5, p. 30-31. The importance attached by British incorporators to limited liability is also shown by the fact that, in advising the Department of Industry and Trade on the feasibility of a new form of incorporation for small firms, Prof. Gower recognized that it would have little chance of acceptance if it did not also confer limited liability. See *A New Form of Incorporation for Small Firms* [A consultative Document], Annexe A, para. 10 (Cmd. 8171, 1981). Prof. Gower reached this conclusion even though the availability of limited liability may be illusory for many small companies because banks usually require a personal guarantee from the shareholders or directors. It is safe to assume that, faced with the same options, Canadian incorporators would react the same way.

perspective, the costs of incorporating a closely held corporation are also remarkably modest. In most of the provincial acts the formalities of incorporation have been reduced to a minimum, as have the annual reporting requirements where they still exist<sup>19</sup>. The governments' incorporation fee is quite manageable<sup>20</sup>. There are no requirements for a minimum amount of paid up capital ; in fact, the corporation need never issue more than a single share where there is only one shareholder. The current acts contain generous provisions enabling the corporation to purchase its own shares, and to enable others to do so, as long as it does not impair the solvency of the corporation<sup>21</sup>. With one irrelevant exception<sup>22</sup>, none of the corporation's financial statements are required to be filed in a public office or otherwise to be made available for general inspection by the public. Finally, the obligation to hold shareholders' and directors' meetings have been greatly simplified. No meeting needs to be held at all if all the shareholders or directors respectively agree on a resolution in writing<sup>23</sup>.

From the perspective of the corporation's creditors, the easy availability of incorporation looks much less attractive and imposes substantial costs. The important costs appear to be the following :

- Easy incorporation fosters a casual attitude to responsible business ethics.

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The British experience appears to undermine the claim of R.E. Meiners, J.S. Mofsky and R.D. Tollinson ((1979) 4 *Del. J. Corp. Law* 351, at p. 364, also cited in J.H. Farrar, *supra*, note 5, p. 68) that the primary reasons for the corporate form of business are not related to the availability of limited liability but are based on (1) the marketability of shares ; (2) perpetual existence ; (3) flexible financing methods ; (4) specialization of management ; and (5) majority rule. The first advantage only applies to public corporations and, in Canada, with proper drafting and the use of trustees, advantages (3), (4) and (5) can be substantially secured by unincorporated partnerships.

19. For example, under the Ontario *Corporations Information Act*, R.S.O. 1980, C.95, s.3(3), a filing is only necessary where there has been a change in the particulars since the previous filing.
20. In 1987, Prince Edward Island had the lowest fee with \$150, the federal government the highest with \$500. Ontario charged \$220 and Quebec had a sliding scale, starting with \$300, which varied with the amount of the authorized capital. Lawyers' fees for incorporating a simple corporation seem to range from \$300 to \$500. Computer programmes enable the documentation to be prepared with minimal effort.
21. See e.g. : CBCA ss. 32, 42 and OBCA, ss. 20, 30.
22. CBCA, s.154(1) (b) requires a CHC whose gross revenues in the accounting year exceed \$10 million, or whose assets exceed \$5 million, to file with the Director the annual financial statements prescribed by s.149. Obviously this requirement will not apply to the overwhelming majority of closely held corporations whose gross revenues and assets fall much below these threshold figures.
23. CBCA, ss.112, 136 and OBCA ss.104, 129.



- It encourages serious undercapitalization of the business and excessive reliance on outside credit. Equally disconcerting is the fact, as *Salomon v. Salomon*<sup>24</sup> shows, that the doctrine of corporate personality enables a shareholder to become a secured creditor of his own corporation, thus further undermining the prospects of payment to the corporation's unsecured creditors if the corporation runs into difficulties.
- It imposes heavy risks of non-payment on voluntary creditors and even greater risks on the corporation's involuntary creditors (tort claimants and municipal, provincial and federal tax claims and such like). The risks are greatly magnified when a business promoter incorporates a flock of affiliated corporations each of which is undercapitalized<sup>25</sup>, or when a solvent parent corporation runs an empire of subsidiaries as if they were part of a single business while insisting on their separate legal personalities if things go awry<sup>26</sup>.
- It leads to a rapid increase in the number of corporate bankruptcies, especially in periods of recession.
- It encourages professionals, and other persons not presently eligible for it, to seek the right to incorporate<sup>27</sup>.

These claims need not be taken at face value and it is necessary to examine them more closely to see how far they are supported by practical experience. So far as the dangers of undercapitalization and other forms of opportunistic conduct are concerned, the point is frequently made that banks, landlords and other large creditors can, and usually do, protect themselves, by requiring the owners of the corporation to give personal

24. *Salomon v. Salomon & Co. Ltd.*, *supra*, note 11.

25. *Clarkson Co. Ltd. v. Zhelka*, (1967) 64 D.L.R. (2d) 457 (Ont.). The issue here however was not the undercapitalization of the affiliated corporations but the shunting of assets among them so as to confuse the bankrupt's creditors. A clearer example of undercapitalization is the celebrated New York Court of Appeals' decision in *Walkovsky v. Carlton*, (1966) 223 N.E. (2d) 6. Another well known example is *Minton v. Cavaney*, (1961) 364 P. (2d) 473 (Cal.).

26. This problem constitutes the focus of Prof. Landers' examination, *supra*, note 9. A good Canadian analogue is *De Salaberry Realities Ltd. v. MNR*, (1974) 46 D.L.R. (3d) 100 (Fed. T.D.).

27. For example, Alberta and British Columbia currently permit the incorporation of chartered accountants, dentists and lawyers, three groups of professionals to whom incorporation was not previously available. For the details, see J.S. Ziegel *et al.*, *supra*, note 1, p.242-243. In Ontario, the *Legal Profession Statute Law Amendment Act*, 1990, S.O. 1990, c.8 (assented to June 28, 1990, but so far only partly proclaimed in force) now also permits the practice of law in corporate form.

guarantees<sup>28</sup>. In the alternative or in addition, these creditors may demand security from the corporation or its principal shareholders, or both<sup>29</sup>. In short, bankers and other large voluntary creditors can effectively contract around the limited liability hurdle. It may also be argued that opportunistic conduct by owners is not as common as is often assumed. Even if they do not invest a large amount of their personal wealth in the corporation, owner-managers *do* contribute a large amount of human capital which gives them a strong incentive to make a success out of the corporation.

So far as trade creditors are concerned, it is generally assumed that they can implicitly insure themselves against the corporation's default by adding a credit risk "premium" to the cash price of their goods or services. However, this is easier said than done. Most small trade creditors do not have credit departments and many are quite unsophisticated in their credit practices<sup>30</sup>. It is also claimed that the short term nature of trade credit enables trade creditors to adjust their credit practices quickly in the light of changing circumstances, and that their knowledge of the trade gives them a superior ability to evaluate the credit risks they are facing. Again, these are questionable assumptions: a debtor corporation can acquire a large amount of supplies on a 30 or 60 days credit basis, especially in cyclical industries, before the supplier becomes aware of the debtor's financial difficulties. Even if the foregoing assumptions are correct, they do not protect the supplier against other

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28. In 1988, in conjunction with Billy Garton, a former student, the writer analyzed 140 randomly selected "business" bankruptcy files in Metro Toronto. 95 were pure bankruptcy files (i.e., files that allegedly involved no personal debts) and 35 were "guarantor" files in which a majority of the debts arose out of one or more business guarantees given by the individual bankrupt. If anything, the guarantor figures underestimate the frequency of guarantees of corporate debts. One very experienced Toronto trustee in bankruptcy recently told the writer that, in his experience, most small corporate bankruptcies also involve a personal guarantee.

29. The recently enacted personal property security legislation in the western provinces and in Ontario make it very easy to take a security interest in all of a debtor's present and future movable assets. See for example the Ontario *Personal Property Security Act* 1989, S.O. 1989, c.16, ss.9-13, and cf. J.S. Ziegel, "Too much, Too Little or Just Right?", (1990) 79 C.B.R. (N.S.) 175. Banks also have the benefit of the special security regime under Section 178 of the *Bank Act*, R.S.C. 1985, c.B-1, although it is not as extensive or as simple as the new provincial regimes.

30. In the Garton/Ziegel bankruptcy study described in the text, unsecured suppliers of goods and services represented 59.6% of the total number of unsecured claims and 62.8% of the total number in value. The rate of recovery by the goods suppliers was 10% compared with a rate of 3% for the services suppliers. The average rate of recovery for all unsecured claims was 5.0%.

forms of opportunistic behaviour in the absence of personal liability by the debtor corporation's owners.

Among the corporation's other voluntary creditors, its employees, especially if they are unorganized, are generally regarded as very vulnerable in the absence of protective legislation. An equally important group exhibiting similar characteristics are consumers—those who prepay for goods that are never delivered or for services that are not provided because of the corporation's collapse<sup>31</sup>. Or again, even if the goods are delivered or the services are rendered, the consumer may lose the benefit of accompanying warranties if the retailer or manufacturer is no longer in a position to honour them.

Among a corporation's involuntary creditors, tort victims are regularly seen as uncompensated risk bearers if the corporation is undercapitalized or fails to carry sufficient insurance<sup>32</sup>. However, tort claims are infrequent in corporate bankruptcies or reorganizations although mega-tort claims will almost certainly lead to the corporation's collapse even if the corporation is insured<sup>33</sup>. How often, however, will a one-person corporation be involved in a mega-tort claim? Curiously, the literature on limited liability generally overlooks a quantitatively much more important group of involuntary creditors—federal and provincial government claims for unpaid taxes and similar assessments against the corporation, or for failure to remit taxes deducted at source. Such claims regularly appear in corporate bankruptcies<sup>34</sup>. However, it must be admitted that Crown claimants are much closer to voluntary creditors in their capacity to anticipate and protect themselves against such defaults, whether by spreading the risk across all tax payers or by giving the Crown a first lien on the debtor's property which takes priority over all other

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31. For a good example of the former type of problem, see *Royal Bank of Canada v. 216200 Alberta Ltd.*, (1987) 51 Sask. Rep. 146 (Sask. C.A.) and Law Reform Commission of British Columbia, *Report on the Buyer's Lien: A New Consumer Remedy*, L.R.C. 93, 1987.

32. See *Walkovsky v. Carlton*, *supra*, note 25.

33. The Johns-Manville Corporation is a high profile example of a U.S. corporation filing for reorganization under Chapter 11 of the U.S. *Bankruptcy Code* because of mega-tort asbestos claims. See *In re Johns-Manville Corp.*, (1984) 36 Bankr. 727.

34. In the Ziegel/Garton study such claims represented just under 5% in dollar value of all claims filed in the 95 pure business bankruptcies.

claims<sup>35</sup>. Crown claims also enjoy preferred status over unsecured creditors pursuant to s.136(1) of the *Bankruptcy Act*<sup>36</sup>.

The overall result then is that closely held corporations that are insolvent are likely to have a broad range of creditors with different characteristics, some of whom almost certainly will not be able to protect themselves adequately against the corporation's default. Does this mean, as has been suggested<sup>37</sup>, that limited liability is an inefficient regime for the closely held corporation and that the corporation's owner should be held personally responsible for some of all of the corporation's unmet liabilities? Before attempting to answer this question we must examine first the law's current response to these problems.

### 3. Statutory and judicial responses

#### 3.1. Statutory responses

British and North American legislatures appreciated from the beginning the potential for abuse of the privilege of limited liability and sought to offset it in a variety of ways. It is not necessary to give an exhaustive list of the techniques used but the following summary will convey the flavour of the most important approaches.

##### 3.1.1. Disclosure of limited liability status

To alert creditors to the fact that they are dealing with a limited liability corporation, the Canadian Acts invariably require the inclusion in the company's name of one of the words "Corporation", "Limited" or "Incorporated" or the abbreviations "Inc." or "Ltd."<sup>38</sup>. Legislation also frequently requires a corporation to set out its names in legible characters "in all contracts, invoices, negotiable instruments and orders for goods and services"<sup>39</sup>. The difficulty about these sensible requirements is that the sanctions for non-compliance are largely ineffectual and usually only

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35. Crown lien claims have sparked a large body of case law, legislative proposals, and professional comment. See *inter alia*: W.A. Bogart, "Statutory claims and personal property security legislation: a proposal" (1983-84) 8 *C.B.L.J.* 129; *Report of the Advisory Committee on Bankruptcy and Insolvency* (Ottawa, Jan. 1986), p. 38s.; and *Kavcar Investments Ltd. v. Aetna Financial Services Ltd.*, (1989) 62 D.L.R. (4th) 277 (O.C.A.).

36. *Bankruptcy Act*, R.S.C. 1985, c.B-3.

37. P. Halpern, M. Trebilcock and S. Turnbull, *supra*, note 7, at p. 147-150.

38. See e.g.: CBCA, s.10(1) and OBCA, s.10(1).

39. CBCA 10(5), OBCA 10(5), and *Corporations Information Act*, R.S.O. 1980, c.96, s. 3.

involve an unenforced summary jurisdiction fine or an equally hypothetical order for compliance<sup>40</sup>.

### 3.1.2. Rules concerning the raising and maintenance of share capital and restrictions on financial assistance

As previously mentioned, the early 19th century corporations Acts frequently contained requirements for a minimum amount of paid up capital and, in England, such a requirement still applies to public corporations<sup>41</sup>. In the other EEC countries a minimum amount of paid up capital is the norm for private limited companies<sup>42</sup>. In Canada, on the other hand, the attempt to impose capitalization requirements was abandoned earlier in this century<sup>43</sup>, presumably because it was felt that such a requirement was arbitrary and largely futile. The modern corporations Acts have gone still further and have repealed or heavily diluted the earlier rules<sup>44</sup> (many of them of judicial origin) preventing a corporation from purchasing its own shares or to provide assistance for the purchase by others of such shares, or prohibiting the payment of

40. In the case of the OBCA the sanctions are a fine (s.257) and an order for compliance (s.252). Some courts have also denied the directors of the corporation the protection of limited liability when the corporation's name was not properly disclosed but the reasoning leading to this conclusion are of doubtful validity. See e.g.: *Wolfe v. Moir*, (1969) 69 W.W.R. 70 (Alta.) and *Tato Enterprises Ltd. v. Rode & Scott Bradley Marketing Ltd.*, (1979) 17 A.R. 432.

41. *Companies Act 1985*, s.118 (the minimum amount is £50,000 or approx. \$120,000).

42. See the table on capital requirements in *A New Form of Incorporation for Small Firms*, *supra*, note 18, p. 41.

43. Until 1883, the federal *Companies Act* (as it was then known) required companies to have a minimum paid up share capital of \$500 "with which a company shall carry on business". See e.g.: *Companies Act*, R.S.C. 1927, c.27, s.9.8. The provision was omitted in the *Companies Act*, 1934, 24-25 Geo. V, c.33, and has not reappeared since. Until 1930, the federal legislation also prohibited companies from commencing operations or incurring liabilities until a prescribed percentage of the company's authorized capital had been subscribed for. See e.g.: *Companies Act*, R.S.C. 1927, c.27, s.28. This provision was deleted by a 1930 amendment. See *Companies Act Amending Act*, S.C. 1930, c.9, s.11.

So far as I have been able to ascertain from the resources at my disposal, the post-1860 Ontario legislation never required a minimum amount of paid up capital. However, the Act of 1864 contained restrictions similar to that in the later Dominion Acts precluding a company from commencing operations until one-half of the proposed capital had been subscribed for in good faith and 10% of the subscribed stock had been paid in. A.W. Currie, *supra*, note 1, at p. 400. These requirements were soon abandoned since they do not appear in the 1877 Revised Statutes. See *The Ontario Joint Stock Companies Letters Patent Act*, R.S.O. 1877, c. 150.

44. See F.W. Wegenast, *The Law of Canadian Companies*, Toronto, Carswell, 1979, ch. XXI, esp. p. 464-467, and p. 477-482.

dividends out of capital. Instead, the contemporary legislation largely confines itself to an insolvency test — will the contemplated activity make the corporation insolvent<sup>45</sup>?

Although there are no general capital raising and maintenance requirements, exceptionally directors are held personally liable for the corporation's debts in two circumstances: (a) for unpaid wages<sup>46</sup>, and (b) to the federal government for unpaid taxes where the failure to pay is attributable to the directors' neglect to exercise reasonable care, diligence and skill in the performance of their statutorily mandated duties<sup>47</sup>.

Canadian insolvency legislation has no provision comparable to s.214 of the *British Insolvency Act 1986* holding a director liable for wrongful trading where he knew or ought to have concluded that there was no reasonable prospect of the company avoiding its insolvent liquidation<sup>48</sup>. Could the same result be reached under the Canadian business corporations acts by holding the director liable in damages for failure to conduct the corporation's affairs in a reasonably prudent manner<sup>49</sup>? Alternatively, could creditors complain that they have suffered damages because of "unfairly prejudicial" conduct by the directors in permitting the corporation to operate without adequate capitalization<sup>50</sup>? The difficulty in both cases is that the director may not have breached a duty owing to the creditor; without such a breach, it may be argued, there can be no liability in damages<sup>51</sup>. However, the possibility of using these

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45. See e.g.: OBCA ss.20, 30, 32, 38.

46. CBCA s.119, OBCA s.131, and see for one of many such cases *Mesheau v. Campbell*, (1983) 141 D.L.R. (3d) 155 (O.C.A.). The statutory provisions are of American origin. See further, D.B. Gleig, "Unpaid Wages in Bankruptcy", (1987) 21 *U.B.C. L. Rev.* 66.

47. *Income Tax Act*, S.C. 1980-81-82-83, c.140, s.124(1), adding s.227.1(3) to the *Income Tax Act*. See further R.L. Campbell, "Directors' Diligence Under the Income Tax Act", (1990) 16 *C.B.L.J.* 48, and E.P. Moskovitz, "Directors' Liability under Income Tax Legislation and Related Statutes", (1990) 38 *Can. Tax J.* 537.

48. See further R.M. Goode, *Principles of Corporate Insolvency Law*, Sweet & Maxwell, London, 1990, p. 203-213. The British offence of wrongful trading must not be confused with provisions such as s.173(c) of the Canadian *Bankruptcy Act*, R.S.C. 1985, c.B-3, entitling a court to refuse the discharge of a bankrupt on the ground that the bankrupt continued to trade after knowing himself to be insolvent.

49. CBCA s.122(1), OBCA s.134(1).

50. CBCA s.241, OBCA s.247.

51. *Western Finance Co. Ltd. v. Tasken Enterprises Ltd.*, (1980) 106 D.L.R. (3d) 81 (Man. C.A.).

provisions as a proxy for obliging the directors to ensure that the corporation is adequately funded should not be excluded entirely<sup>52</sup>.

### 3.1.3. Publicity

The Canadian Acts require the filing of information in a public office giving the location of the corporation's head office or registered office and giving the names of its current directors<sup>53</sup>.

Prescribed records must also be maintained at the corporation's head office and made accessible there to shareholders and creditors<sup>54</sup>. However, none of these provisions enable creditors to determine the solvency of the corporation since the information of record does not include any of the corporation's financial reports. The creditor must obtain this information by other means. This is in striking contrast with the position under the *British Companies Act* where, since 1967, private companies, no less than public companies, have been obliged to file prescribed financial statements with the Registrar of Companies<sup>55</sup>.

### 3.1.4. Conclusion

The upshot of this cursory examination of the statutory provisions is that, with modest exceptions and subject to one or two larger but untested possibilities, the Canadian corporations acts do remarkably little to protect creditors against the abuses of limited liability. Apparently the creditors are expected to fend for themselves. Their position compares very unfavourably with that of minority shareholders who, it is generally

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52. CBCA s.122(2) and OBCA s.247(2) do not require the complainant to prove the breach of a duty owing to it, only that (*inter alia*) the powers of the directors have been exercised in a manner that is oppressive or unfairly prejudicial or that unfairly disregards the interests of any "security holder, creditor, director or officer" of the corporation. "Complainant" is broadly defined in CBCA s.238, OBCA s.244(b). It may therefore be open to an aggrieved creditor to argue that it is prejudicially affected if the directors permit the corporation to operate knowing it is seriously undercapitalized. Whether the court will accept this argument is another matter. These issues were not raised in *Western Finance v. Tasker Enterprises*, *supra*, note 51.

53. CBCA s.19 and Regs. Forms 3 and 6, and *Corporations Information Act*, *supra*, note 39, s.3.

54. CBCA s.21, OBCA s.140, s.145.

55. *Companies Act 1985*, Pt. VII, ch. II, now replaced by *Companies Act 1989*, ch. II, and see further J.H. Farrar *et al.*, *supra*, note 5, p. 478, p. 481-82. The scope of the required disclosures under these provisions is much smaller than for public companies. For the EEC's disclosure requirements for small companies, see EEC 4th Company Law Directive 78/660 and J.H. Farrar *et al.*, *supra*, note 5, p. 458-60.

agreed, have been treated very solicitously under the recent legislation<sup>56</sup>. Given the statutory lacuna, the challenge facing the courts is to respond where the legislatures have remained silent. How far have the judges been willing to accept the call ?

### 3.2. Judicial responses—Lifting the corporate veil

A preliminary difficulty that faces a creditor seeking to persuade a court to ignore the corporate veil in order to hold the owner-directors of the closely held corporation personally liable is to present a credible theory for his argument. What entitles the court to ignore the separate personality of the corporation and the well established proposition that debts and obligations incurred on behalf of the corporation are the corporation's debts and obligations and not those of the individual actors ? How does the tribunal overcome the stern statutory admonition that "the shareholders of a corporation are not, as shareholders, liable for any liability, act or default of the corporation" except where so provided"<sup>57</sup> ?

The difficulties are not as formidable as they may appear at first sight. The business corporations acts are not an exhaustive code of all the rules and principles applicable in this branch of commercial law ; unquestionably, they presuppose that the general principles of contract, tort, agency, tort and other branches of private law will continue to apply. The same will be true of the transcendent principles of "loyalty, good faith, and avoidance of a conflict of duty and interest" that govern the conduct of the corporation's officers and directors<sup>58</sup> and their duty to act "honestly, in good faith and in the best interests of the corporation". Indeed, these duties are expressly enjoined on them in the legislation<sup>59</sup>.

It appears then that Canadian courts are not nearly as handicapped in preventing abuses of the corporate form as is often supposed. True, they have not been as willing (or imaginative ?) in using their powers as have their more activist American brethren, but this is attributable to a more cautious judicial temperament and not to a lack of suitable weapons in the legal armoury. Rather, a survey of the case law indicates that the appropriate doctrines are in place for an effective policing role by the courts even if they have not yet been used widely for this purpose.

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56. For the details, see F. Iacobucci, M.L. Pilkington, and J.S. Prichard, *Canadian Business Corporations*, Toronto, Canada Law Books, 1977, ch. 6(D).

57. CBCA s.45, OBCA, s.109.

58. Cf. Laskin J. in *Canadian Aero Services Ltd. v. O'Malley* [1974] S.C.R. 592, at p. 620.

59. CBCA s.122(1)(a), OBCA s.134(1)(a).



To illustrate, principles of "estoppel" have been invoked to impose personal liability on a director who misrepresents the status of his enterprise<sup>60</sup>. The "fraud" doctrine has been applied to prevent circumvention of restrictive covenants and other contractual obligations by the interposition of the corporate veil<sup>61</sup> and, it would seem, is available to enable creditors of a bankrupt debtor to reach assets concealed from them by the same device<sup>62</sup>. The rule that every person is accountable for his tortious conduct is increasingly being invoked to hold directors liable for improperly procuring breach of a contract by the corporation<sup>63</sup> or authorizing the infringement of patent rights<sup>64</sup>. "Agency or instrumentality" concepts are a familiar and favourite judicial device for denying tax advantages to a corporate subsidiary or affiliate that has no authentic existence but is only a puppet in the hands of the parent corporation<sup>65</sup>. In one case<sup>66</sup>, the Supreme court of Canada even applied a "business

60. See inter alia *Wolfe v. Moir*, *supra*, note 40, *West Fraser Builder Supplies v. Vander Horst*, [1990] B.C.J. No. 146 (B.C.C.A.), and *Royal Stores Limited v. Brown*, (1956) 5 D.L.R. (2d) 146 (B.C.). Estoppel principles appear to have been overlooked in *B.G. Preeco (Pacific Coast) Ltd. v. Bon Street Holdings Ltd.*, (1989) 60 D.L.R. (4th) 30, 43 B.L.R. 67 (B.C.C.A.), on which see Comment by J.H. Farrar in (1990) 16 C.B.L.J. 474.

61. *Gilford Motor Co. v. Holmes*, [1933] Ch. 935; *Jones v. Lipman*, [1962] 1 W.L.R. 832; and *Big Bend Hotel Ltd. v. Security Mutual Casualty Co.*, (1979) 19 B.C.L.R. 102 (S.C.) (material non-disclosure of insurance risk). See also *Manley Inc. v. Fallis*, (1977) 2 B.L.R. 277 (O.C.A.) where the court treated the parent company and its subsidiary as one person for the purpose of establishing fiduciary breach by an employee.

62. *Clarkson Co. Ltd. v. Zhelka*, (1967) 64 D.L.R. (2d) 457 (Ont.). The case is sometimes cited to illustrate Canadian courts' reluctance to lift the corporate veil even where fraudulent conduct is alleged. A careful reading of Thompson J's judgment shows however that his conclusion was based on other grounds, in particular the trustee's failure to show how he had been prejudiced by the bankrupt's conduct and the fact that there were no complaints from creditors of the companies whose assets had been manipulated by the bankrupt.

63. See for example *McFadden v. 481782 Ontario Ltd.*, (1984) 47 O.R. (2d) 134 (Ont.), and cf. W.A. Richardson, "Making an End Run Around the Corporate Veil: the Tort of Inducing Breach of Contract", (1984) 5 *Adv. Q.* 103.

64. *Mentmore Mfg. Co. Ltd. v. National Merchandising Mfg. Co. Inc.*, (1978) 89 D.L.R. (3d) 195 (F.C.A.) and cf. *C. Evans & Sons Ltd. v. Spritbrand Ltd.*, [1985] 2 All E.R. 415 (C.A.).

65. See *De Salaberry Realities Ltd. v. M.N.R.*, *supra*, note 26, *aff'd* (1976) 70 D.L.R. (3d) 707 (F.C.A.), and the many earlier authorities cited in Decary J's judgment.

66. *Covert v. Nova Scotia*, [1980] 2 S.C.R. 774.

purpose'' test to determine the true beneficiaries for the purpose of a provincial *Succession Duties Act*<sup>67</sup>.

All these techniques are promising. However, it must be acknowledged that so far they have only been used sparingly to impose personal liability on the owners of closely held corporations. Some Canadian courts have flatly refused to lift the corporate veil where the principal complaint was that the corporation was chronically undercapitalized<sup>68</sup>.

#### 4. The public choice question

Where do we go from here? In an earlier paper<sup>69</sup>, Halpern, Trebilcock and Turnbull argued that unlimited liability is the most efficient regime for the owners of closely held corporations. As an abstract proposition it has much to commend it. With one clean stroke it will dispose of the abuses and externalities generated by the limited liability rule and restore incorporation to its more legitimate functions. Gone will be the need for statutory provisions for the protection of creditors (or as many of the requirements as remain) and for all the elaborate techniques and rationalizations for lifting the corporate veil.

However, the authors' conclusion is not without its difficulties. To begin with, as they themselves recognize, unlimited liability is only important for involuntary creditors such as tort claimants<sup>70</sup> and for a limited group of voluntary creditors, such as employees, who cannot readily contract around the limited liability rule. So far as tort claimants are concerned, it has been previously suggested that statistically they do not present an important class. In the motor vehicle area, the area that in the past has attracted most attention, legislators have shown themselves

67. The business purpose test is of American origin and was first applied in a tax case by the U.S. Supreme Court in *Gregory v. Helvering*, (1934) 293 U.S. 465. It was belatedly embraced by the House of Lords in *W.T. Ramsay Ltd. v. I.R.C.*, [1981] 2 W.L.R. 449 but rejected by the Supreme Court of Canada in *Stuart Investments Ltd. v. R.*, (1984) 10 D.L.R. (4th) 1. See further J.W. Durnford, "The Corporate Veil in Tax Law", (1979) 27 *Can. T.J.* 282.

68. The best known example of this genre is the Ontario Court of Appeal's decision in *Rockwell Developments Ltd. v. Newtonbrook Plaza Ltd.*, (1972) 27 D.L.R. (3d) 651. The court's judgment was written by a well known conservative judge and apparently the court was not asked to lift the corporate veil to attach personal liability to the individual officer. In any event, the decision has not sat well with either legislators or other courts. See now *Ontario Rules of Civil Procedure*, Rule 56 (security for costs) and the decision in *269335 Alberta Ltd. v. Starlite Investments Ltd.*, (1987) 18 C.P.C. (2d) 161 (Alta. Q.B.).

69. R. Halpern *et al.*, *supra*, note 7, at p. 148-150.

70. The authors do not discuss the effects of a limited liability regime on other involuntary creditors such as governmental agencies and Crown corporations. See *supra*, p. 1084.

responsive in introducing insurance requirements of growing severity and with expanded third party coverage that ensure compensation for tort victims much more effectively than unlimited liability for incorporators ever could. Environmental issues are now receiving the same close scrutiny.

Another difficulty is that the authors mistakenly assume that rules that force the corporation's owners to assume personal liability for their acts will eliminate uncompensated for risks. This is only partially true. It will not prevent unqualified or underfunded individuals from embarking on risky activities. As Easterbrook and Fischel have rightly observed<sup>71</sup>, all persons, incorporated or not, enjoy limited liability because everyone's resources are finite. This is the reason why bonding, insurance and licensing requirements will continue to be necessary in sensitive areas of the economy whether or not owners of closely held corporations are held personally responsible for the corporation's debts<sup>72</sup>.

Still another difficulty is that the authors would apparently deny limited liability to *all* the shareholders in a closely held corporation regardless of their involvement in the management of the corporation. This goes too far and would put inactive shareholders in a worse position than limited partners in a limited partnership<sup>73</sup>.

Leaving aside these specific difficulties, there is a broader public choice question that must be addressed. Who is agitating for removal of the limited liability regime for closely held corporations? Who would support it if the proposal were made? The likely constituencies are not obvious. Potential tort victims not protected by existing legislation would be difficult to organize. Powerful voluntary creditors capable of protecting themselves (large lenders and landlords and such like) would probably be indifferent. Other more vulnerable voluntary creditors (mainly small trade creditors) are themselves beneficiaries of the limited liability regime and presumably would not wish to shoot themselves in the

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71. R. Halpern *et al.*, *supra*, note 7, at p. 90.

72. Financial intermediaries accepting deposits from the public are a paradigmatic example of legislators imposing strict licensing and depositary insurance requirements for the benefit of depositors. In the consumer area, many of the provinces impose licensing (and in some cases bonding) requirements on such diverse occupations as door to door selling, debt collection agencies, and motor vehicle dealers. In addition, industry sponsored insurance funds exist to protect consumers against the insolvency of stockbrokers and investment dealers, life and health and casualty insurance companies, travel agencies, and builders of new homes.

73. Under modern limited partnerships Acts a limited partner is only liable as a general partner if he takes part in the control of the business. See for example the *Limited Partnership Act*, R.S.O. 1980, c.241, s.12.

foot. If forced to choose, consumers and similar unincorporated constituencies would probably opt for more focused remedies that address their concerns such as licensing, bonding or insurance requirements<sup>74</sup>. Finally, owners of closely held corporations would complain loudly that “the little guys”, “the backbone of the modern economy”, were being discriminated against in favour of the shareholders of public corporations.

These practical considerations lead one to conclude that a modified version of the status quo—a combination of statutory requirements or liabilities coupled with more active judicial lifting of the corporate veil to prevent the most obvious abuses—is likely to be the most attractive prescription despite its obvious imperfections and uncertainties. This is not to suggest that society can afford to be complacent or to suggest that governments should do nothing. What it does indicate is that governments will likely only be receptive to second order remedies and probably only those that are not too visible or likely to arouse violent opposition.

If we must settle for such compromise solutions, what changes should be recommended? Strengthening the sanctions for non-compliance with the corporate name disclosure requirements is an obvious and relatively uncontroversial step. However, the requirements themselves need some refining. A more important reform is to require all closely held corporations, and not merely public corporations, to file annually a simplified copy of their financial reports with a view to lending a minimum amount of transparency to their activities and state of solvency.

Resurrecting the old requirements for a minimum amount of paid up capital would undoubtedly engender much opposition unless the amount was nominal. Moreover, the requirement has little to commend it. Unless a complex scheme of classification were adopted<sup>75</sup>, any statutory figure would be quite arbitrary and would not ensure the solvency of the corporation. It would also tie up scarce resources since many corporations are quite inactive or are only set up for a limited purpose<sup>76</sup>.

A better option would be to strengthen the provisions in the federal *Bankruptcy Act*. This would also have the advantage of imposing a

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74. It is unlikely, for example, that the owner-managers of a wholesale travel agency would be able from their own resources to compensate the prospective travellers in a plane full of passengers if the flight was cancelled or the travellers found themselves stranded at the destination. Several of the provinces have addressed the problem by introducing an industry wide insurance plan.

75. As is true, for example, in the case of depository financial institutions whose solvency is of major public concern.

76. For example, to act as a vehicle for a takeover offer.

uniform set of rules across Canada and avoid a competition in laxity among provincial corporations regimes<sup>77</sup>. Subordinating loans made by an owner to her own corporation or by a parent corporation to a subsidiary would be a possibility though almost certainly unpopular<sup>78</sup>. A less controversial provision would be to allow the court to subordinate a non-arm's loan between the corporation and its controlling shareholder if the terms were found to be unfair. A much more important proposal would be to introduce a wrongful trading liability provision comparable to section 214 of the British *Insolvency Act*. This would act as a powerful proxy for an adequate capitalization requirement and would make it much more difficult for irresponsible company promoters to walk away unscathed from a collapsed enterprise. Undoubtedly the proposal also has significant disadvantages since it could involve difficult and expensive litigation.

The combined effect of these suggestions should be to improve the flow of information to creditors and make incorporation less attractive than it is at the present time. It also presupposes a vigilant and sympathetic judiciary since without the co-operation of the courts the new provisions may prove to be spineless.

One further step can be recommended without hesitation. We need much more detailed information about the effects of limited liability and its impact on particular classes of creditors. We would also benefit greatly from learning how successful the EEC countries have been in curbing the abuses of the corporate form of business organization without denying their owners the benefits of limited liability.

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77. The "Delaware" phenomenon and its impact on shareholder welfare have in recent years provoked a substantial body of scholarly literature in the U.S. See J.S. Ziegel *et al.*, *supra*, note 1, at p. 234-235. For an excellent examination of the virtues and disadvantages of competing corporations Acts in the Canadian context, see R. Daniels, "Should Provinces Compete? The Case for a Comprehensive Corporate Law Market" (publication pending in the McGill Law Journal). Whatever the benefits that incorporators may derive from easy incorporation, it should be clear that a uniform regime for the protection of creditors' rights is superior to ten provincial regimes. The Canadian Fathers of Confederation rightly appreciated this distinction when they conferred the bankruptcy power on the federal government. See *Constitution Act 1867*, s.91(21).

78. It would be argued that a rule of automatic subordination would deprive the borrower corporation of a cheap source of loan capital or deprive it of access to outside funding where its credit rating is too poor to make it eligible for commercial loans.